IN THE

Supreme Court of the United States

OCTOBER TERM 1975

No. 75-580

ALLIS-CHALMERS MANUFACTURING COMPANY,
Petitioner,

v.

GULF & WESTERN INDUSTRIES, INC.,
Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION

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Gulf & Western Industries, Inc. ("G&W") submits this memorandum in opposition to the petition for a writ of certiorari filed by Allis-Chalmers Manufacturing Company ("Allis") on October 16, 1975. Because of the Court's current review of *Foremost-McKesson, Inc.* v. *Provident Securities Co.,* No. 74-742, which involves the same issue on different facts, G&W does not believe it appropriate formally to oppose the granting of such petition, but does oppose the arguments made and result sought by petitioner, and it submits that the holding below should be summarily affirmed.

Moreover, we submit that the writ may properly be denied and the decision below left to stand because the circumstances of the instant case differ significantly from those in the *Foremost-McKesson* case, and the decision below was correctly decided as to liability. G&W was an undisputed "outsider" when it acquired its Allis shares, did so in an Exchange Offer involving extensive federal

regulation and disclosure, was treated by Allis as an "undesirable suitor" and "unwanted mate", and sold only after extensive disclosure was again made. No abuse of inside information did occur or possibly could have occurred, and the statutory purpose cannot be served by the imposition of liability. The result below should stand in any event.

G&W also proposes to file a petition for a cross-writ of certiorari to review a different aspect of the decision below concerning valuation within the time allowed.

Restatement of the Question Presented[1]

Whether the purchase by which an outsider—which has no prior relationship to the issuer and never becomes an officer or director—acquires more than ten percent of a class of such issuer's securities must be included as a § 16(b) transaction, despite the statutory proviso mandating that § 16(b) "shall not be construed" to cover such a transaction, where the acquisition was preceded by full disclosure as to the issuer's financial condition and where there was "no possibility under the facts of this case" (*5a*) that such outsider could have used inside information in its acquisition.

Restatement of the Case

Petitioner omits so many facts relevant to the decision below that it is necessary to submit this counterstatement.

1. Pursuant to Rule 21, G&W has requested the Clerk of the Court of Appeals for the Seventh Circuit to transmit the printed joint appendix, agreed upon by both parties for use in the court below, to this Court. Citations in the text in the form: "(5a)" are to the joint appendix; other citations are to trial exhibits not included in the appendix. Because petitioner has chosen a form of pagination for its appendix to the petition which is identical to that of the joint appendix, we have distinguished the two citations by using italics for citations to petitioner's appendix, *e.g.*, "(*5a*)".

A. Background of the Exchange Offer

In early 1967 Allis' earnings dropped sharply (636a-37a) and the decline continued into 1968 (610a, 641a, 1132a). Allis became involved in several announced merger attempts which, however, were abandoned because of discouragement by Allis' management or apprehension of business risks. (Dx-JJJJ-1, at 16, 18-25). A California investment firm, claiming unhappy Allis shareholders as clients, encouraged G&W to seek an interest in Allis (315a). On May 6, 1968 Charles G. Bluhdorn, G&W's chairman, and David N. Judelson, G&W's president, advised Allis' then chairman, Robert S. Stevenson, that G&W was contemplating an exchange offer for Allis and would keep Allis informed (317a, 588a-89a, 1316a-19a; Dx-JJJJ-1 at 29-30). Bluhdorn affirmed to Stevenson that G&W sought no control of or directorships in Allis (*id.*, 30-31, 34).

On May 7 Bluhdorn told Stevenson that disclosure rules required G&W to announce the Exchange Offer immediately, and pointed out that Allis' financial statements would be required for the offering Prospectus. Stevenson said Allis would cooperate (319a, 592a, 1317a, Dx-JJJJ-1 at 39-41), but pressed Bluhdorn again to confirm that G&W sought no merger or control. (592a-95a, 1317a-19a, 1400a-02a, Dx-JJJJ-1 at 41-42). That day G&W announced that pursuant to a Registration Statement it would make an Exchange Offer to all Allis shareholders to acquire up to 3,000,000 Allis shares on a pro rata basis, offering in exchange for each share:

(a) $11.50 in cash;

(b) $12.50 principal amount of 6% G&W Subordinated 20-year debenture due 1988 (the "G&W 6% Debenture"); and

(c) 9/10 of a 10-year G&W Warrant to purchase G&W common stock at $55 per share (the "G&W Warrant")

(593a, 1400a-01a), and this was immediately carried on the Dow Jones "broad tape" (1402a).

B. G&W's Effort to Provide Full Disclosure in the Exchange Offer

G&W's counsel on May 10 requested the cooperation of Allis' general attorney in preparing the Exchange Offer Registration Statement and Prospectus, as required by SEC rules to provide full disclosure of Allis' current condition[2] (1430a). Stevenson was so advised, and on May 17 Allis replied that it would "do anything within reason to cooperate in furnishing material for such registration statement" (1405a), and alerted its independent accountants (1407a). Counsel for Allis, G&W and several investment bankers conferred continually and scheduled a disclosure conference at Allis' headquarters for June 20 (526a-27a, 1547a).

On June 14 Stevenson arranged a meeting with Allis' officers and counsel to precede the disclosure meeting (1547a). Then, on his own initiative, he went to G&W's headquarters on June 18 and saw Judelson, in Bluhdorn's absence (609a; Dx-JJJJ-1 at 60). He said that he told Judelson only by way of an unspecified, numberless "inkle" that the "direction" of Allis' "earnings" was "downward" (610a-11a; Dx-JJJJ-1 at 61).[3] He explained that he visited G&W because he knew G&W was preparing disclosure documents and "didn't want any omissions or overstatements" (659a-60a; Dx-JJJJ-1 at 61-62), but used the opportunity to discourage G&W's acquisition (Dx-YYY at 14-16; 611a; Dx-JJJJ at 61-65).

2. SEC Rule 409, 17 C.F.R. § 230.409; General Instruction F to SEC Form S-1, 2 CCH Fed. Sec. L. Rep. ¶ 8006 at 7016. G&W offered to and did reimburse Allis for all its fees and expenses in connection with disclosure. The information regarding Allis was to appear in other registration statements for other transactions, and a number of other investment bankers' counsel were therefore very concerned with the propriety of disclosure (1408a).

3. Afterwards, Stevenson claimed he got his impression from what he called a "grid", which was at no time mentioned or shown to anyone at G&W (656a, 675a).

At the June 20 disclosure meeting Allis' representatives and counsel for G&W and the investment firms cooperated in securing and reviewing detailed information concerning Allis and formulating language to convey the information fully in the Prospectus (538a-39a). Allis' management and counsel critically reviewed the Prospectus disclosure (543a-44a). Allis' counsel cautioned management that all current statements "must be true on the effective date" and urged a "careful review" to ensure "accuracy and completeness" (1409a).

It was undisputed that G&W published all the material facts about Allis' business and financial condition in the Prospectus (1123a-41a) under the title "Information Concerning Allis-Chalmers". Indeed the Prospectus included Allis' projection of second quarter earnings (702a, 1132a) and noted certain adverse cost and price trends in 1967 which continued to affect its earnings in 1968 (*id.*).

Allis' management "decided that the disclosure had been very complete" (616a), and took no position on G&W's offer, because the Prospectus would give "all of the Allis-Chalmers stockholders . . . all the facts and figures" (651a). G&W representatives had no information about Allis other than that published in the press and in the Prospectus (319a-20a, 1482a-87a). Allis' management, lawyers and accountants each gave G&W formal written assurance that the Prospectus disclosure, as furnished by Allis, was complete and accurate in all material respects. (1421a-24a; 697a; 1425a).

C. The Exchange Offer and Continuing Disclosure

The Prospectus became effective June 1, 1968 (1031a-1142a) and was mailed by Allis to every Allis shareholder

at G&W's expense. The offer was subject to G&W shareholder approval at a meeting set for July 29, 1968, pursuant to a proxy statement setting forth the material on Allis (1018a-29a). Pursuant to the Prospectus G&W would accept up to 3,000,000 shares, pro rata up to July 19, and thereafter in order or receipt (1033a).

Disclosure continued throughout the offer. On July 5 Allis announced that its 1968 first half earnings would be substantially less than in 1967 (1433a-34a). G&W reaffirmed its offer despite Allis' decline, stating it sought a long-term investment (1436a). On July 16 Allis released half-year earnings of 45¢ (down from 81¢ in the first half of 1968).

Response to the Exchange Offer was quick and positive. By July 19 well over 3,000,000 shares had been properly tendered (1442a, 1459a). G&W's shareholder meeting on July 29 approved the offer, despite Allis' recurring setbacks, and thereby gave G&W for the first time more than 10% ownership of Allis' common stock (1145a).

D. Allis' Isolation of G&W Subsequent to the Exchange Offer

Allis' treatment of G&W was described in its own brief to the trial court: "No enterprise which finds itself the object of an undesirable suitor", it said, "need adopt an attitude of friendliness toward the unwanted mate."[4] This confirmed G&W's own apprehension of an "iron curtain of silence" following the Exchange Offer (323a). No G&W representative ever served as a director or officer of Allis, nor did G&W have any voice in Allis' management (662a-63a; 671a). On August 7 Allis slashed its regular quarterly dividend from 25¢ to 12½¢, as part of "its fighting" of G&W (*69a*). G&W had no warning of, and no participation in, the decision (622a-23a; 321a, 671a). Stevenson told Bluhdorn concurrently with public an-

4. Allis Post-trial Brief, Part II, May 14, 1973, at 27.

nouncement that there would be no advance discussion on such matters, because disclosure rules barred discussion "outside of a board of directors room" (615a).

On August 6 Mr. Bluhdorn had telephoned Mr. Stevenson to renew G&W's offer of technical assistance by suggesting that a G&W manufacturing vice-president, recognized by Allis as very capable, visit and assist in any way deemed convenient (321a, 613a). Upon his arrival on August 12, Allis gave him a "stockholder's tour of one of the facilities" (Dx-YYY at 11) and told him in effect that Allis would "like to be left alone . . . to mind their own business" (321a). G&W sent no further representatives.

On August 14 Bluhdorn was called by a Milwaukee newspaperman regarding a press conference called by Allis (321a-22a). Bluhdorn was ignorant of it and, not wishing to appear "foolish", telephoned Stevenson (321a-22a), but Stevenson said that "the information is not available to any one this evening" (618a). The next day, concurrent with "broad tape" announcement, Stevenson telephoned Bluhdorn, saying that Allis had just appointed a new president (323a). G&W had no part in any discussions regarding a new president (323a, 662a) and was never informed of Allis' search for one (619a-20a) because Allis viewed this as an "internal matter" which "should be kept to the board of directors and the management" (619a-20a).

E. Oppenheimer Purchase and the October 21 Press Release

G&W entered into an agreement (1154a-62a) with Oppenheimer Fund, Inc. ("Oppenheimer"), dated August 28, 1968, to acquire 248,000 Allis shares in exchange for 496,000 G&W Warrants and a price guarantee. Its consummation depended upon the satisfaction of certain conditions no later

than September 30, 1968, and the closing was held on that date.

Prior to the Oppenheimer closing, Stevenson came to New York on September 13, 1968 to see Bluhdorn and Judelson. On the eve of the Exchange Offer, the FTC had advised G&W and Allis that it intended to commence a formal proceeding to examine the effect of the proposed acquisition under the antimerger laws (1023a; 1469a). Bluhdorn complained that Allis' "planning department" was purposely misleading the FTC by asserting that Allis proposed to enter businesses similar to G&W's (328a-29a) although Allis' financial condition made such plans unrealistic (636a-37a, 1132a, 1441a, 1478a-80a, Dx-YYY at 23-25, 27-28). Stevenson denied this (622a), but parried the suggestion that Allis might invite Judelson to become a director by suggesting that the FTC would disapprove (625a). Although this was the first time he had met Bluhdorn, Stevenson concluded Bluhdorn was getting "nervous" (625a). To Judelson it was clear that Bluhdorn was "entirely frustrated" by the "ridiculousness of Allis-Chalmers going into ventures that would cost them two or $300 million . . . frustrated . . . not by their full cooperation with the [FTC] but by the mentality that would say you're going to do this sort of thing" (147a).

Stevenson said that during this meeting he gave G&W an unquantified "inkle" about Allis' continuing decline (622a). But according to Judelson, Stevenson never told G&W "anything" about Allis' affairs (1479a) and Bluhdorn's testimony was the same (323a, 334a). Critically, Stevenson's notes of the meeting, bearing the notation "major points" (1330a), contain no mention that Allis' performance was discussed at all, and Stevenson so admitted (663a-65a, 1330a, 1545a-46a). Because of this, along with Stevenson's uniform isolation of G&W from Allis' internal

processes (593a-95a, 597a, 613a, 615a, 618a, 662a, 671a) and other serious testimonial inconsistencies,[5] the trial court found that the substance and purpose of Stevenson's conversation was to "discourage G&W's retention of its stock position in Allis" (*48a*).

Subsequent events further belied Stevenson's recollection of the September 13 meeting, and made it irrelevant. On October 21, Stevenson met with Bluhdorn and others to advise G&W "at precisely the same time that the rest of the world and his shareholders were being informed" (330-31a, 628a-31a, 667a) that the "broad tape" was carrying Allis' projection of a $50 million loss in 1968 from both operating results and write-offs (330a-33a, 628a-29a, 667a). Far from being forewarned, this hit Bluhdorn "like a thunderbolt" (330a), and Stevenson conceded that G&W's officers were completely unprepared and "floored" (668a). The October 21 announcement appeared widely in the press along with detailed information on Allis' earnings prospects (702a-03a, 1494a-1503a). There were no other meetings, and G&W sold no Allis shares until well after the October 21 public announcements.

F. G&W's Sale of Allis Stock

Press reports of Allis' October 21 announcement indicated that G&W had received inquiries to purchase its Allis

5. Apart from the disparity between his careful notetaking and his testimony, Stevenson, who took early retirement in March 1969 (630a-31a), did not always remember to include the portion about giving an "inkle" in the September 13 conversation (1545a-46a), and had to be reminded of it by counsel (Dx-JJJJ-2 at 128), and could never articulate what he supposedly said to G&W but would only characterize it vaguely as "hints", "inkles" and "important" (see 611a, 622a, 656a). His testimony also included a monologue on the evils of exchange offers (600a-03a), claiming that G&W had inflicted "material damage" on Allis by buying its shares (691a-92a). However, the evidence showed instead that the financial failures of Allis long predated the Exchange Offer (636a-37a, 1435a), and were homegrown, as Stevenson's immediate successor, David C. Scott, frankly admitted (1498a-1503a).

shares (1503a). Stevenson took part in discussions to encourage G&W to sell to the Fiat interests in Italy (Dx-JJJJ-2 at 126-127). In late September, White Consolidated Industries, Inc. ("White") and G&W began discussions (347a, Bluhdorn dep. 87-90), and on October 31 they announced that White would acquire G&W's Allis shares (Dx-GGGG, ex. 4).

The agreement (the "White Agreement"), dated as of October 31, 1968 but not made final until later, contained numerous conditions to be satisfied at the closing (1163a-76a). On December 6, 1968, G&W sold its Allis shares to White in exchange for (a) 250,000 unregistered shares of White common stock; (b) an unsecured 8½% promissory note in the face amount of $93,680,000 payable in 6 months; and (c) only $20,000,000 in cash, since White had not been able to borrow more at that time (1163a-64a, 1222a, 1230a, 1506a). White announced its purchase as part of a plan to acquire Allis (1507a).

G. Subsequent Events (Related Primarily to the Cross-Petition)

Shortly after the closing and again in March 1969, G&W tried to sell the White note through a New York investment house, but was told that the note was "not financible" and would have to be factored at a 10% to 15% discount from its face value (484a-89a, 492a-93a, 497a). Twelve days after the closing, Allis moved for a preliminary injunction in a Delaware federal court to block White's acquisition on antitrust grounds (1519a). White's chief financial officer gave evidence that if its investment in Allis stock were inhibited, White would incur "serious adverse" financial consequences and face severe difficulty in discharging the note (1520a). Allis lost its motion on January 22, 1969, *Allis-Chalmers Manufacturing Co.* v. *White Consolidated Industries, Inc.*, 294 F. Supp. 1263 (D. Del. 1969), and the Third

Circuit denied its application for a temporary restraining order pending appeal on February 3, 414 F.2d 506, 509, n.5 (3 Cir. 1969).

Following Allis' apparent defeat, White secured a credit agreement on March 5 by which it obtained funds to discharge the note then held by G&W (1219a), and caused the note to be paid on March 20 with interest (1295a). But on May 5, the Third Circuit enjoined the annual meeting at which White hoped to gain control (1536a; 414 F.2d at 509 n.6). On July 18, 1969 it reversed the district court and enjoined White from voting any or acquiring additional Allis shares or seeking board representation, thereby halting White's takeover attempt (414 F.2d at 526). The banks which had given White loans to pay the note became "very concerned" and sought financing from other sources because of White's financial trouble (499a-500a). This could not be arranged until 2 years later (500a, 1253a).

While it was pursuing its claims against White in Delaware, Allis commenced this action against G&W in the Eastern District of Wisconsin on January 6, 1969.

The Proceedings Below

A. The District Court

This case was tried in March 1973 on both issues of liability and the amount of profits, if any, on which expert economic testimony was adduced. The district court found G&W had no access to inside information either before or after it acquired Allis shares (*47a*); that there had been "no showing of wrongdoing" (*72a*); and that G&W "did nothing wrong, as far as speculative abuses are concerned" (*74a*). Rather G&W had been the target of a program of isolation and hostility by Allis' management, the court finding, *inter alia*, that Allis had halved its dividend "in its

fighting" of G&W (*69a*). Nevertheless the court felt constrained to impose technical liability and awarded $1,135,838 of "profit realized." However, it reflected its distaste for Allis' position by refusing its request for an award of dividends and prejudgment interest, calling these "unconscionable" and "retributive" on the facts of the case (*id.*).

B. The Court of Appeals

Allis did not pursue its claims for dividends and interest on appeal but continued to press certain valuation doctrines designed arbitrarily to "maximize" the recovery under § 16(b), claiming its $1.1 million windfall should be increased to over $12 million. G&W principally appealed on the issue of liability. The Court of Appeals for the Seventh Circuit, in an opinion by Judge Swygert for a panel including Judge Pell and Mr. Justice Clark, unanimously held that G&W's initial exchange offer acquisition was outside the scope and purpose of § 16(b), and rehearing en banc was denied upon a poll of the full court (*6a n.5*). Expressing general agreement with the Ninth Circuit's decision in *Provident Securities Co.* v. *Foremost-McKesson, Inc.*, 506 F.2d 601 (9 Cir. 1974), the court held that the purchase by which an outsider with no prior relationship with the issuer acquires more than 10% of the issuer's shares does not trigger § 16(b)'s automatic liability.

The court of appeals found, as had the district court, that "there is no possibility under the facts of this case that Gulf & Western could have made 'unfair use of information . . . obtained . . . by reason of [its] relationship to [Allis-Chalmers]'" in making the Exchange Offer acquisition (*5a-6a*). Examining the statutory language "in its totality" as well as the legislative history, the court determined that "the statute was never intended to reach such a transaction." (*6a*)

Rather, the court found, "Congress had in mind a specific type of two-part transaction consisting either of a purchase and subsequent sale, or a sale and subsequent repurchase" (*15a*), which Congress had viewed as a "conceptual unit" (*16a*). Since "the section was aimed at preventing speculation based on abuse on inside information, the section must have contemplated a *pre-existing* beneficial interest" (*id.*). Where the investor lacked insider status prior to the opening purchase, the court reasoned, "the full purchase/sale transaction could hardly be characterized as 'speculative' from the standpoint of insider abuse" (*id.*). Thus, G&W's acquisition of Allis shares in the Exchange Offer was held outside the statute.

Because G&W's purchase from Oppenheimer occurred when G&W was already a 10% owner, the court found liability. It also held that the district court had overstated the purchase price G&W paid to Oppenheimer by valuing incorrectly G&W's guarantee of the future value of its warrants. This resulted in increasing Allis' recovery by $1,106,080.

With respect to the value of the unusual $93,680,000 White note, the court disallowed the discounted fair market value which had been found by the district court on the basis of the evidence. The Court did not contend that the district court's finding was "clearly erroneous", but held that fair market value was not the applicable test; rather, the face amount of the note was said to be controlling (whatever the actual value) if paid before trial. This aspect of the decision is the subject of G&W's cross-petition. This revaluation of the note would have exposed G&W to a $4 million addition to the judgment, if the Court had not found the 3,000,000 Exchange Offer shares outside the statute.

Certain other determinations concerning valuation are not relevant here. Moreover, because the court held that

G&W's purchase while an outsider was not within the statute, it was not required to consider certain other issues (which would remain for consideration on remand should this Court disagree with the decision of the court of appeals[6]).

Contrary to certain erroneous suggestions made in the petition (at 7) and in oral argument by counsel for Foremost-McKesson, Inc. in No. 74-742 (Transcript at 9, October 7, 1975), G&W has always contended that the initial acquisition by an outsider is not a chargeable "purchase" under § 16(b). Specific references to the statutory proviso are contained in two affirmative defenses raised in G&W's answer (46a-47a). Indeed, it will be recalled that G&W was granted leave by the Court to file a brief as amicus curiae in *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418 (1972) in support of its position, urging that the question here not be indirectly reflected upon in the *Reliance* case, since it was not then before the Court at the instance of the parties.[7] The Court's opinion expressly noted, "that question is not before us." 404 U.S. at 421.

6. These issues include: (1) whether the acquisition by exchange offer is excludable under the "pragmatic" test, even if the court's assessment of the statutory proviso is erroneous; (2) whether the district court erroneously refused to recognize, for valuation purposes, the essentially undisputed impact of arbitrage on G&W warrants during the exchange offer, thus charging G&W with an artificially low purchase price for the Allis shares (see *57a n.6)*.

7. Motion of Gulf & Western Industries, Inc. for Leave to File the Accompanying Brief as Amicus Curiae in Support of the Position of the Respondent, No. 1332, October Term 1971, pp. 2-4.

The Decision Below on the Question Presented Should be Summarily Affirmed if Certiorari is Granted; Alternatively, the Writ May Properly be Denied.

Respondent does not oppose the grant of a writ of certiorari—although it believes the decision below to be correct—because the same legal issue on different facts is currently under review in the *Foremost-McKesson* case. Respondent was permitted to file a brief as amicus curiae in that case, which is appended hereto.[8] However, it has not had, and would welcome, the opportunity of plenary argument so that the "first-purchase issue" might be appraised in light of the compelling facts in its own case. Moreover, because the facts differ substantially from those in *Foremost-McKesson*, we submit that certiorari may be denied here whatever the result in that case.

The statutory purpose cannot be served by treating G&W's acquisition by Exchange Offer—announced well in advance, available to all shareholders on an open and equal basis, and preceded by complete financial disclosure—as if it were an insider's purchase on advance information. G&W was an "outsider" when it made the Exchange Offer (*46a*). Afterwards it was viewed and treated by Allis as an "undesirable suitor" and "unwanted mate". It sold its shares only after it had been systematically isolated by Allis' management and put remote from its enormous investment, and following further public disclosure of Allis' financial condition (1494a-1503a). There was no access to inside information. Given the undisputed sequence of events and disclosures, G&W could not use it even if it had any. The statutory purpose cannot be served by the imposition of a purposeless liability.

Petitioner's position would treat a defendant who owned *none* of the issuer's shares at the time of its purchase the

8. Citations to respondent's prior brief as amicus curiae are in the form "(1b)".

same as one who already owned over ten percent, thereby treating outsiders and insiders alike. Such an illogical reading would subvert the terms of the statute, its rationale and its purpose, as revealed by the legislative history. Specifically, the statutory proviso, applicable only to *non-managerial* "beneficial owners", expressly bars liability except where the specified "relationship to the issuer" existed "at the time of" the purchase. This gives an unmistakable basis for charging an otherwise innocent—and indeed, as here, a potentially beneficial—commercial event. Otherwise, the statute would act as a capricious barrier to important economic transactions.

Thus, when petitioner tries to deprecate the statutory exemption, saying it makes liability depend upon the "calculated or fortuitous reason that the beneficial owner purchased all such stock in one transaction," (Pet. at 9), this simply ignores the very basis upon which Congress made liability depend as an essential, elemental matter, *viz:* the specified "relationship to the issuer" at the time the purchase is undertaken.

This is not to say that there is no federal policy respecting the acquisition of a large block of shares by an outsider. Rather, that type of transaction raises concerns which are very different from those inherent in the problem of insider trading, and is addressed by other areas of the federal statutory system.[9] This Court has said, "If there are evils to be redressed by way of deterring those who would make tender offers, § 16(b) does not appear to us to have been designed for this task", *Kern County Land Co.* v. *Occidental Petroleum Corp.*, 411 U.S. 582, 597-98 (1973). The blurring of these quite different problems underlies petitioner's arguments.

A related error inheres in petitioner's reliance (Pet. at 13) on the decision in *Reliance Electric Co.* v. *Emerson Electric Co., supra,* which, to the contrary, makes clear the inapplicability of the statute here. The heart of the problem in *Reliance* was that the "second sale" could analytically be viewed as within the statutory intent, because "tainted" by the same presumed access to information that infected the immediately preceding "first sale". The question therefore was whether the express statutory exclusion could be avoided so that the second sale might be reached, but the Court rejected the proposed circumvention. Here, there is not even an analytical argument that the initial purchase is theoretically tainted by access to inside information. Thus, given the statutory exemptive language, liability would *a fortiori* be wrong. Indeed, the whole thrust of the *Reliance* decision was to reinforce the exemptive proviso, holding that it is one of the "objective standards" of § 16(b) which "cannot be disregarded", 404 U.S. at 423, 424.

There has never been a satisfactory basis for charging an outsider's initial ten-percent transaction, and there has been no consistent line of authority to support it. For almost 15 years, there were only two decisions on the issue, each contrary to the other: one, *Stella* v. *Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952), decided on a preliminary motion and later affirmed without analysis by a divided court, 232 F.2d 299 (2 Cir.), *cert. denied,* 352 U.S. 831 (1956); the other, *Arkansas-Louisiana Gas Co.* v. *W. R. Stephens Investment Co.*, 141 F. Supp. 841 (W.D. Ark. 1956), which was not appealed.

The decision in the *Stella* case (in which there was no liability because there were no profits), was based upon the theory of *recurrent* insider status where, hypothetically, an investor could buy stock, sell down to under ten percent, and then repeat the process "ad infinitum", 104 F. Supp. at

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9. Congress recently revised regulations covering this area in the Williams Act Amendments to the Securities Exchange Act of 1934, §§ 13(d)-(e); 14(d)-(f); 15 U.S.C. §§ 78m(d)-(e); 78n(d)-(f). Moreover, where, as here, the outsider offers its own securities in the acquisition, it must file a Registration Statement and Prospectus under the Securities Act of 1933, and must attempt to set forth detailed information about the financial condition of the issuer of the shares to be acquired, as well as its own. SEC Rule 409, 17 C.F.R. § 230.409; General Instruction F to SEC Form S-1, 2 CCH Fed. Sec. L. Rep. ¶8006 at 7016. See pp. 4-5, *supra.*

959. There are several difficulties with the theory, not the least of which is that it has not the slightest application where the defendant, as here, had no prior relationship at the time of the very transaction in question. Another is that hypothetical "taint" is not a basis for ignoring the exemption. *Reliance Electric Co.* v. *Emerson Electric Co., supra.* Yet a more basic one is that a stockholder trading in and out of a ten percent position does not even fit the mold of the "insider" which Congress envisioned as the likely possessor of inside information. Indeed, this Court suggested in *Reliance* that

> "it may be that Congress regarded one with a long-term investment of more than 10% as more likely to have access to inside information than one who moves in and out of the 10% category." 404 U.S. at 424.

The next time it spoke on the issue, in *Newmark* v. *RKO General, Inc.*, 425 F.2d 348 (2 Cir.), *cert. denied,* 400 U.S. 854 (1970), the Second Circuit did not adopt the rationale of the *Stella* case. Rather, in dictum not remotely related to the facts of its case, the court first conceded that the initial purchase *cannot* be presumed to be based on inside information, but added that *subsequently* acquired information would enable the alleged insider "to sell his shares at the moment most advantageous to him." 425 F.2d at 356. These comments were pure dictum, since the court found that the defendant both was in fact a statutory "beneficial owner" *before,* and actually used inside information at the time of, the purchase. *Id.* But beyond this, the suggestion in the *Newmark* dictum has uniformly been criticized as irrelevant to the problem and providing the basis for only a Rule 10b-5 action—if indeed there was actual use of inside information. See *e.g., Gold* v. *Sloan,* 486 F.2d 340, 349 (4 Cir. 1973), *cert. denied,* 419 U.S. 873 (1974); Comment, *Section 16(b): An Alternative Approach to the Six-Month*

Limitation Period, 20 U.C.L.A. L. REV., 1289, 1297 (1973); Note, *Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?,* 117 U. PA. L. REV. 1034, 1041-42 n. 39 (1969).

Not surprisingly, the Second Circuit in *Perine* v. *William Norton & Co.,* 509 F.2d 114 (2 Cir. 1974), while paying respect to its own prior decisions, nevertheless substantially undercut their support by holding that, if any underwriter who made a ten-percent purchase was not a "pre-existing insider", it was not required to satisfy all conditions of SEC Rule 16b-2 in order to exempt the transaction. It thus gave determinative weight to the absence of a prior inside relationship in a § 16(b) case involving a mere shareholder. 509 F.2d at 120-121.

Petitioner wholly ignores that Congress made assumptions with respect to managerial insiders (officers and directors) very different from those respecting nonmanagerial shareholders, and that this distinction underlies the statutory proviso at issue. *Adler* v. *Klawans,* 267 F.2d 840 (2 Cir. 1959). Officers and directors have not merely a probability of access to, but indeed a duty to become apprised of, internal corporate information. In contrast, large shareholders need never have such access; and the circumstances surrounding the acquisition of shares are not predictable. Clearly, large shareholdings may be acquired without any confidential involvement. The instant case, involving unquestioned compliance with federal advance disclosure requisites, is exemplary.

According to its draftsmen, § 16(b) was:

> "aimed at protecting the public 'by preventing directors, officers, and principal stockholders of a corporation . . . from speculating in stock on the basis of information not available to others' S. Rep. No. 792, 73d Cong., 2d Sess., 9 (1934)" *Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 592.

Disclosure, especially by an outsider, goes to the heart of the problem at which § 16(b) was aimed, as the Fourth Circuit noted recently:

> "[I]t is the unfair use of inside information against which the statute is directed and plainly where there has been full disclosure . . . the potential for unfairness and any basis for invoking the statute disappears." *Gold* v. *Sloan, supra,* 486 F.2d at 349.

An Exchange Offer, characterized by safeguards against unfairness, is wholly unsuited for § 16(b)'s brand of abuse. The open offer to all shareholders, ratable treatment, the premium above market value, the possibility of substantial future benefits for both corporations involved, and especially the full prior disclosure of all material financial information—all set an Exchange Offer starkly apart from the covert market trading which Congress had in mind in enacting § 16(b).

Indeed, one much-cited article contrasts an exchange offer and its counterpart, the cash tender offer (the "purchases" in the *Kern County* case), from the viewpoint of trading fairness. While on one hand a cash tender offer is merely a "form of a market purchase", on the other "an exchange offer closely resembles a merger transaction", inextricably bound up with the provision of "sufficient information" as to the target corporation and surrounded by numerous safeguards.[10] "Exchange Offers are unusual."[11] One made by an outsider can hardly be viewed

10. A. Fleischer & R. Mundheim, *Corporate Acquisition by Tender Offer,* 115 U. Pa. L. Rev. 317, 348-349 (1967).

11. "Exchange Offers are unusual. First, . . . they must be registered under the Securities Act of 1933 and will have to comply with state Blue Sky laws. . . . Second, to make the requisite disclosures about the sought-after company may require the cooperation of management. . . . Third, exchange offers lack the element of surprise. . . . Finally, in an exchange offer involving registration under the

as one of the "class of transactions in which the possibility of abuse was believed to be intolerably great," *Reliance Electric Co.* v. *Emerson Electric Co., supra,* 404 U.S. at 422, and to which the statute is limited. *Id.*

The issue in *Kern County* was whether the "closing" transaction was a sale. Where the question is whether the opening acquisition is chargeable as a § 16(b) "purchase", the inquiry asks whether the acquisition was "an anticipatory action based upon inside information" looking toward a subsequent profit-taking sale. Comment, *supra,* 20 U.C.L.A. L. Rev. at 1295. In *Gold* v. *Sloan, supra,* the Fourth Circuit held that inquiry into an opening transaction must focus upon the critical period *preceding* the alleged "purchase", and that

> "if there is in the transaction itself, and the negotiations leading up to it, an absence of abuse, then the deterrent force of the statute is unnecessary and liability is not in order." 486 F.2d at 343.

In appraising whether an opening transaction would be charged, it held that the relevant facts were those leading up to the transaction, since

> "circumstances or events occurring after the transaction in question cannot possibly be relevant in determining whether there was a possibility of speculative

Securities Act, [the offeror] is severely restricted under § 5 of the act, 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77e (1964), with respect to statements made. . . .

"[U]nless stock has already been authorized, the offeror must secure a vote of its shareholders for an appropriate amendment to its charter. . . . [I]ssuance of the shares in connection with the exchange offer may need shareholder approval under certain state laws. . . . or, under the rules of the major exchanges. . . . See, e.g., New York Stock Exchange, Company Manual A-284(3). Finally, if the shares to be issued by the offeror constitute a substantial part of its outstanding stock, it may be contended that the transaction constitutes a de facto merger. . . ." *Id.* 348 n. 119.

abuse when such transaction occurred," 486 F.2d at 349.[12]

When G&W decided to make its Exchange Offer, it had no association with Allis and was not even a shareholder; thus its decision "could not have been based on inside information obtained from substantial stockholdings that did not yet exist." *Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 597. To comply with disclosure rules, it announced its decision immediately (1400a-01a), stating the exact consideration it would offer (*id.*). This amount, determined while G&W was an outsider (*46a*), never varied (1031a). The announcement gave the market ample time to anticipate the offer and adjust for it. *See* Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach,* 72 MICH. L. REV. 592, 612 (1974). In the next two months G&W made intensive disclosure efforts, even paying Allis' costs to ensure the quality and completeness of disclosure. Both G&W and Allis were subject to severe civil and criminal sanctions for any material deficiency in the disclosure,[13] and there was no deficiency (546a-47a). Allis, its lawyers and accountants gave G&W written assurance that the disclosure was complete (1422a-32a). Indeed the Prospectus even provided the latest earnings projections and assessments of price and cost trends (1132a) at the insistence of counsel (1415a). G&W could acquire no shares under the Exchange Offer until after the information was distributed to the investing public. In addition, in voting upon the Exchange Offer, G&W's shareholders had exactly the same information as did Allis' shareholders; the proxy statement and the Prospectus were substantially identical. This was simply unsuited to unfair informational abuse. Disclosure about Allis continued throughout the offering period (1433a-41a). Although the news indicated further deteriorating earnings —continuing the trend since 1967—G&W nevertheless went forward with the acquisition at a premium price.

12. "[F]ocusing on the possibility of inside information after the initial transaction is an irrelevant criterion" when the issue is whether an initial acquisition is an abusive "purchase". Comment, 20 U.C.L.A. L. REV., *supra,* at 1297. *See also Perine* v. *William Norton & Co., supra.*

13. 15 U.S.C. §§ 77k, *l*, q, x; SEC Rule 409, 17 C.F.R. § 230.409; General Instruction F for Form S-1, 2 CCH FED. SEC. L. REP. ¶ 8006 at 7016. G&W would be strictly liable for any faults in disclosure. 15 U.S.C. § 77k. Moreover, the intentional provision of false information would give rise to criminal liability under the 1933 Act for aiding and abetting. Rule 10b-5, issued under § 10 of the 1934 Act, 15 U.S.C. § 78j, also bore directly on G&W and Allis' disclosure obligations. *See, e.g., S.E.C.* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 839, 891 (2 Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); *Heit* v. *Weitzen,* 402 F.2d 909 (2 Cir. 1968), *cert. denied,* 395 U.S. 903 (1969); *Escott* v. *BarChris Const. Co.,* 283 F. Supp. 643 (S.D.N.Y. 1968).

Such a transaction could not possibly have been in anticipation of a short-swing profit based on inside information. Full disclosure at the critical time (or the pointed absence of it), has been given repeated emphasis in § 16(b) cases,[14] since "if any relevant information that an insider may have prior to beginning his short swing is shared by the investing public, there is no 'possibility' of abuse." Note, *supra,* 72 MICH. L. REV. at 611 (1974). Similarly, the idea that Allis should gain a windfall recovery because it succeeded in its policy of isolating G&W, which had offered Allis shareholders both a premium price and the prospect that Allis' decline might be reversed through professional aid, must be "repugnant to our sense of

14. *See Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 600; *Roberts* v. *Eaton,* 212 F.2d 82, 83 (2 Cir.), *cert. denied,* 348 U.S. 827 (1954) (proxy statement provided a "full discussion of the proposal"); *Ferraiolo* v. *Newman,* 259 F.2d 342, 346 (6 Cir. 1958), *cert. denied,* 359 U.S. 927 (1959) ("full disclosure was made"); *Petteys* v. *Butler,* 367 F.2d 528, 537 (8 Cir. 1966), *cert. denied,* 385 U.S. 1006 (1967) ("the stockholders were adequately informed"). *Compare: Newmark* v. *RKO General, Inc., supra,* 425 F.2d at 356.

equity." See *Abrams* v. *Occidental Petroleum Corp.*, 450 F.2d 157, 164 (2 Cir. 1971), *aff'd sub nom. Kern County Land Co.* v. *Occidental Petroleum Corp., supra.*

Although subsequent events do not directly bear on whether an opening acquisition was based on inside speculation, they are nevertheless instructive in showing how Allis contrived to dispose of its "unwanted mate". Allis' management could not appeal to the Allis shareholders to refuse G&W's offer or otherwise openly oppose because Allis' shareholders were "unhappy" with management, "antagonistic", and upset in particular by its apparent undoing of previous offers (639a-640a). Nor could management arrange a "defensive merger", as in *Kern County,* since it had alienated the likely candidates (DX-JJJJ-1 at 16, 18-22). Instead, it adopted a covert policy to discourage G&W and put it remote from its investment. G&W was even worse off than "simply a disaffected stockholder . . . tolerated but not welcomed by the management", *Gold* v. *Sloan, supra,* 486 F.2d at 344, because G&W was not tolerated.

Allis slashed its dividend right after G&W made its acquisition, advising G&W only simultaneously with public announcement and making it clear that there would be no advance consultation (615a). When Bluhdorn suggested in passing that Judelson might be invited onto the Allis board, Stevenson recorded it in his notes as a "threat" (1326a); the next time he hid behind the FTC inquiry (625a). When G&W sent an expert manufacturing trouble-shooter to Allis' headquarters to give aid, he was run through one facility and sent back to New York (321a, 613a). While Allis searched for a new president, it kept G&W totally in the dark, so that even a Milwaukee newspaperman knew more about Allis than G&W did, and Allis would say nothing when G&W inquired (618a). And although Stevenson claimed at trial that he gave G&W weighty and important "hints" and "inkles" about Allis' performance at his September 13 visit, all the hard evidence suggested other-

wise. His notes disclose no discussion of Allis' performance (1330a), and even Stevenson conceded that when he subsequently told G&W, simultaneously with public announcement on October 21 (330-31a; 667a), of Allis' real financial results, G&W's officers, far from reflecting forewarning, were "floored" (667a). G&W sold no shares until well after Allis' public disclosures. The trial court rejected Stevenson's professed motives, and saw his September 13 visit to G&W as part of the continuing effort to give G&W a sour and distant view of its enormous investment in Allis (*48a*). Even Stevenson's own version was robbed of any relevance by the financial disclosures of October 21.

Because G&W has previously devoted attention to unfolding of the legislative history preceding the enactment of Section 16(b) (10b-17b), it would not be useful to dwell on it here, except to take note of the attack made by petitioner on the analysis of both the Seventh Circuit and the Ninth Circuit (Pet. at 12-13). The entirety of that attack is based, as we best understand it, on the claim that it was somehow error for these courts to go back to "a Senate bill" (*id.* 12)—which, petitioner fails to point out, was the "Fletcher-Rayburn" bill introduced in *both* the House and Senate[15]—in order to assess the intent of the legislation. In fact, the Fletcher-Rayburn bill alone was the subject of the legislative hearings which are uniformly relied upon as establishing the purpose and operation of this statute. (See note 15, *infra*) Indeed, when petitioner claims that a

15. S. 2693, introduced by Sen. Fletcher and referred to the Senate Banking and Currency Committee, February 9, 1934, considered in *Hearings on S. Res. 84 & S. Res. 97 Before the Senate Committee on Banking and Currency,* 73d Cong., 2d Sess. (1934); H.R. 7852, introduced by Rep. Rayburn and referred to the House Committee on Interstate and Foreign Commerce, February 10, 1934, considered in *Hearings on H. R. 7852 Before the House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. (1934).

subsequent unspecified "House bill" must be regarded as the "lineal predecessor" of Section 16(b) (Pet. at 12) this turns out to be an entirely arbitrary choice of pedigree, and simply wrong. The only bill voted upon by the House prior to the conference committee's final version was H.R. 9323, which omitted entirely the provision now known as Section 16(b). See 12b-13b.

Finally, petitioner's repeated invocations of the statutory "purpose" as a basis for liability deserve no consideration, for they beg the question and ignore the fact that the purpose of the statute is a limited one. Section 16(b) is served by giving it application "without extending the reach of the statute beyond its intended limits." *Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 595. A purchase by an outsider who never becomes an officer or director is not logically, nor within the statutory language, one of the "class of transactions in which the possibility of abuse is intolerably great," *Reliance Electric Co.* v. *Emerson Electric Co., supra,* 404 U.S. at 422, and is therefore not within the automatic liability imposed by the statute.

Conclusion

For the reasons stated, the writ of certiorari may be granted and the decision below summarily affirmed on the question presented, or, in the alternative, the writ of certiorari should be denied, since the decision below was clearly correct.

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APPENDIX

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Illinois, *Allis-Chalmers Manufacturing Co.* v. *Gulf & Western Industries, Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974). A principal issue there is whether an outsider's initial acquisition of a greater than 10% interest must, on any facts, be a chargeable transaction, in the face of the statutory exemption which states that the statute "shall not be construed" to impose liability where "such beneficial owner was not such both at the time of the purchase and sale".

G&W concededly had no prior relationship to the issuer. It acquired 3,000,000 shares in a single transaction pursuant to a public exchange offer, preceded by a full, indeed extraordinary, disclosure effort (regarding *both* G&W and Allis) in conformity with the Securities Act of 1933, 15 U.S.C. §§ 77a-aa, and other laws. The trial court has found that G&W "did nothing wrong as far as speculative abuses are concerned" (372 F. Supp. at 591), that there had been "no showing of wrongdoing" (*id.*, 590) and that G&W did not have confidential corporate information "either before or after its purchase" (*id.*, 579). Immediately after the acquisition, G&W became the target of a program of isolation and hostility by Allis' management, the court finding, *inter alia*, that Allis had used a dividend cut "in its fighting" of G&W (*id.*, 589). Nevertheless, the court felt bound to impose technical liability and awarded $1,135,838 of "profit realized".[1] However, it reflected its distaste for Allis' position by refusing its requests for an award of dividends and prejudgment interest, calling them "unconscionable" and "retributive" in the circumstances (*id.*, 589). It is a clear case where liability cannot possibly serve the statutory purpose.

1. A subsequent smaller acquisition is also at issue there.

On its appeal Allis has dropped these claims for dividends and interest but insists that the windfall recovery of $1.1 million was too meager, urging that arbitrary profit-"maximization" rules compel an award of over $12 million. G&W cross-appealed, principally on the critical issue of liability. Because the number of shares involved in G&W's first and concededly innocent acquisition is very large, G&W's stake in the issue before this Court is very substantial.[2]

Questions That May Not Be Adequately Presented by the Parties

Section 16(b) clearly requires that a shareholder-defendant be an insider "at the time" of the purchase, not afterwards—thus conforming to the idea that the decision to purchase be based on the statutorily specified "relationship to the issuer" and the information presumably gained thereby. However, some have claimed to find an "ambiguity" in the statutory language which is said to give license to enlarge liability based on expansive "policy" arguments. Under governing precedent, the issue here must be resolved (1) strictly within the statutory terms, *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418 (1972), or (2) if there is ambiguity, on the specific facts of each case to determine if liability would serve the limited aims of the statute, *Kern County Land Co.* v. *Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973).

In either case, it seems critical that the decision here have the perspective of other real-world situations involving the same issue. The facts of the instant case are highly particularized, and the parties have little reason to focus

2. G&W was previously granted leave to present its views as *amicus curiae* concerning the exemptive proviso in *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418 (1972).

upon possible results in other circumstances, such as in the *Allis-Chalmers* case under review in the Seventh Circuit. That case indicates, possibly better than any other, the error in fabricating liability without proof of wrongdoing where there has been no prior statutory "relationship to the issuer" and there is no possibility of the "types of speculative abuse that the statute was designed to prevent." 411 U.S. at 594 n. 26.

In that case, not only was there no pre-acquisition "inside" relationship, but instead of capitalizing on inside information, G&W undertook to guarantee prior disclosure. Its acquisition was by registered exchange offer pursuant to prospectus,[3] made at a premium above market, announced well in advance, and offered on a pro rata basis. G&W persuaded Allis to collaborate, if not cooperate, in the disclosure process,[4] paid the expenses of its accountants, lawyers, and management in doing so, and demanded and received from each a certification of disclosure accuracy. The result was a highly detailed description of the business condition of both companies—which, particularly in the case of the issuer (Allis), exceeded traditional standards by estimating future earnings and projecting cost and price trends.

Once G&W had finalized its acquisition, it was isolated by Allis. Internal matters were consistently kept from G&W on the basis that it was outside "management". With

3. The "unusual" protective and nonspeculative conditions surrounding exchange offers are described in detail in Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. Pa. L. Rev. 317, 348 n. 119 (1967).

4. See Instruction F to Form S-1, CCH Fed. Sec. L. Rep. ¶7122, at 6202 (1971) (requiring the exchange offer prospectus to set forth business and financial information with respect to the respective issuers of *both* the securities sought and those being offered); and SEC Rule 409 issued under the Securities Act of 1933, 17 CFR §230.409 (requiring the offeror to seek disclosure from the target corporation).

a $115 million investment adrift, G&W, encouraged by Allis, sold its shares to another large industrial corporation which sought them for the purposes of merger. Again, no sale took place until well after public disclosure by Allis of important current financial results.

A "first purchase" by an outsider in an exchange offer based upon full prior disclosure simply does not fit the mold of the statutory target:

> "After all, it is the unfair use of inside information against which the statute is directed and plainly when there has been full disclosure, as is given by a proxy statement, the potential for unfairness and any basis for invoking the statute disappears." *Gold* v. *Sloan*, 486 F.2d 340, 349 (4 Cir. 1973), *cert. denied*, 419 U.S. 873 (1974).[5]

It is with the aim of bringing consideration more directly to bear on such a situation and to contribute the views developed in our litigation that we respectfully request the privilege of submitting the accompanying brief as *amicus curiae*.[6]

Respectfully submitted,

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5. Prior disclosure, or the lack of it, has repeatedly been emphasized in § 16(b) cases in determining whether there should be liability. *Kern County Land Co.* v. *Occidental Petroleum Corp., supra*, 411 U.S. at 600; *American Standard, Inc.* v. *Crane Co.*, 510 F.2d 1043, 1054 (2 Cir. 1974); *Roberts* v. *Eaton*, 212 F.2d 82, 83 (2 Cir.), *cert. denied*, 348 U.S. 827 (1954); *Ferraiolo* v. *Newman*, 259 F.2d 342, 346 (6 Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Petteys* v. *Butler*, 367 F.2d 528, 537 (8 Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967). *Compare: Newmark* v. *RKO General, Inc.*, 425 F.2d 348, 356 (2 Cir.), *cert. denied*, 400 U.S. 854 (1970).

6. Allis has similarly moved to file a brief as *amicus curiae* ("Allis Br.").

BRIEF IN SUPPORT OF THE POSITION OF THE RESPONDENT

Question Presented

Whether the purchase by which an outsider with no prior relationship with the issuer acquires more than ten percent of any class of the issuer's securities must be included as a transaction within § 16(b), despite the statutory exemptive proviso stating that § 16(b) "shall not be construed" to cover such a transaction.

Summary of Argument

Section 16(b) is a special recovery tool, designed to take away profits made by corporate "insiders" in linked "purchases" and "sales" of stock within six months, based upon advance inside information. Because the statute can create liability in the absence of wrongdoing and because of the availability of other remedies in the event of actual abuse, this Court has held that § 16(b) should not be expanded beyond its intended limits. Yet in the situation before the Court liability cannot possibly serve the statutory purpose. Rather, the petitioner would ignore the express statutory exemptions and seeks an automatic rule which would extract recovery from those who are statutory outsiders at the time they buy, and cannot be presumed to have inside information, but rather often provide affirmative disclosure.

The legislative history shows that Congress aimed at a set of transactions by those with a confidential "relationship to the issuer," enabling them to buy, intending or expecting to make a profit on a shortswing sale. Whatever other assumptions may have been made with respect to managerial insiders (officers and directors), Congress clearly distinguished the situation of those who held shares but

were not part of management, since neither the process of obtaining ten-percent ownership nor the position held upon attaining such status necessitates confidential involvement with the issuer. The express proviso bars shareholder liability except when the requisite status existed at the time of the purchase, so that there would be an unmistakable basis for charging an otherwise innocent commercial transaction.

Attempts to force liability in these circumstances are in direct conflict with the logic of the statute and plainly incompatible with the major elements of its operation, including the six-month holding provision, the statutory measure of recovery, and underlying presumption which sustains the statute.

There are no valid "policy" arguments which can support artificially labeling an outsider's investment as an abusive transaction by an insider. To the contrary, decisions of this Court have required that the "proofless" liability of Section 16(b) be confined to situations where liability will serve the statutory purpose and respect its intended limits, and such decisions cannot be squared with the enlargement of liability sought by the petitioner here.

Argument

A. The statute and its purpose

Section 16(b) was designed to attack short-swing trading by officers, directors and certain large shareholders "in the stock of their own companies with the benefits of advance information." S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934). The Congressional target was the situation in which the "insider" purchased on favorable inside information and sold when the price rose (or sold on unfavorable information and then repurchased). "Inside information" is that acquired "by reason of his relationship to the issuer", 15

U.S.C. § 78p(b). While its general purpose is to "preclude the 'unfair use of information . . . by' corporate insiders," it is clear that,

> "Congress did not seek to accomplish the whole of this purpose by section 16(b) alone . . . [which] creates a special remedy, applicable only in a limited situation. . . . [O]ther remedies are . . . available, but only upon proof of actual wrong-doing." *Blau* v. *Max Factor & Co.*, 342 F.2d 304, 307 (9 Cir.), *cert. denied*, 382 U.S. 892 (1965) (footnote omitted).

Because § 16(b) creates an "extraordinary liability" which may attach without proof of wrongdoing, the Court has consistently held that neither the statute nor rules in aid of its implementation may be expanded beyond its limited scope in the guise of effecting some remedial purpose,[7] *Blau* v. *Lehman*, 368 U.S. 403, 411-13 (1962). In *Blau* v. *Lehman*, *supra*, the Court rejected a supposed "prophylactic" rule which would subject partnership profits to § 16(b) by treating a partnership as a statutory "insider" if a partner was one. In *Reliance Electric Co.* v. *Emerson Electric Co.*, *supra*, the Court turned aside a reading of the statute which would have weakened the very exemption at issue here—despite supposed "policy" arguments to the contrary. 404 U.S. at 424.

In the landmark case *Kern County Land Co.* v. *Occidental Petroleum Co.*, *supra*, the Court emphasized that the public interest lies in the implementation of § 16(b) *"without extending the reach of the statute beyond its intended limits."* 411 U.S. at 595 (emphasis added). The Court stressed that the statute's potential for imposing liability without wrongdoing has necessitated a measured approach: "Under these strict terms, the prevailing view is to apply the statute only when its application would serve its goals." *Id.* The Court gave final authority to the modern "pragmatic" view that there is no public interest in the imposition of "purposeless harshness." See *Blau* v. *Max Factor & Co.*, *supra*, 342 F.2d at 307.

7. This view of § 16(b) contrasts with that taken of § 10, the Act's broadly-based antifraud provision which affords a federal remedy against those who are proved to have done actual harm. Indeed, the efficacy and breadth of § 10 eliminates the need for expansionary application of § 16(b); *see, e.g.*, Note, *Reliance Electric and 16(b) Litigation: A Return to the Objective Approach?*, 58 Va. L. Rev. 907, 914-15, 928-29 (1972); Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 Cornell L.Q. 45, 61-64 (1968), both cited by the Court in the *Kern County* case, 411 U.S. at 594 n. 26.

B. The legislative history shows clearly that Congress intended as the target of § 16(b) the investor with inside information as the basis of its opening transaction.

Virtually all recent critical commentators strongly reject the idea that the initial more-than-10% transaction by an outsider should be subject to § 16(b) as both indefensible logically and inconsistent with the legislative purpose. Note, *Securities—Section 16(b)—Initial Purchase of Ten Percent of a Class of Equity Securities Is Not a Section 16(b) Purchase*, 43 Fordham L. Rev. 678 (1975); Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 Mich. L. Rev. 592, 597 n. 26, 602-19 (1974); Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period*, 20 U.C.L.A. L. Rev. 1289, 1294-1300, 1312-13 n. 125 (1973); Note, *Reliance Electric and § 16(b) Litigation: A Return to the Objective Approach?*, 58 Va. L. Rev. 907, 910-11 (1972); Comment, *Exchange of Stock Pursuant to a "Defensive Merger" is Not a "Sale" Within the Meaning of Section 16(b)*, 72 Colum. L. Rev. 1090, 1101-02 (1972); Comment, *Exchange of Stock Pursuant to Merger is "Sale" by Insider under Section 16(b) of Securities Exchange Act of 1934*, 84 Harv. L. Rev. 1012, 1022 n. 30

(1971); Note, *Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?*, 117 U. Pa. L. Rev. 1034, 1042 n. 39 (1969); Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn to Kill the Rats"*, 52 Cornell L. Q. 69, 75 (1966); Comment, 70 Harv. L. Rev. 1312 (1957); Comment, 9 Stan. L. Rev. 582 (1957); W. Painter, Federal Regulation of Insider Trading 41-42 (1968).

The specific "evil which Congress sought to prevent", *Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 594, by means of § 16(b) is clear from the history of the act. The original "Fletcher-Rayburn" bill[8] rendered unlawful[9] any purchase by specified persons made "with the intention or expectation" of selling the same security within six months:

> "It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than five per centum . . .
>
> (1) To *purchase* any such registered security *with the intention or expectation of selling* the same security within six months . . ." (emphasis supplied)

To establish civil liability, actual proof of such intention "in entering into such transaction" was specifically excluded:

> ". . . and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer, *irrespective of any intention or expectation on his part in entering into such transaction* of holding the security purchased for a period exceeding six months." (emphasis supplied)

8. S. 2693, introduced by Sen. Fletcher and referred to the Senate Banking and Currency Committee, February 9, 1934, considered in *Hearings on S. Res. 84 & S. Res. 97 Before the Senate Committee on Banking and Currency,* 73d Cong., 2d Sess. (1934), hereinafter *Senate Hearings;* H.R. 7852, introduced by Rep. Rayburn and referred to the House Committee on Interstate and Foreign Commerce, February 10, 1934, considered in *Hearings on H. R. 7852 Before the House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. (1934), hereinafter *House Hearings.*

9. Section 24 of S. 2693 imposed criminal penalties for willful violation of any provision of the act.

The bill's chief spokesman explained at the Senate hearings (specifically focusing on the case of a director) that the statute used a presumption to obviate proof of the insider's intention *"at the time he bought"*:

> "That [bill] is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. . . . You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on the short swing."[10]

The statute aims expressly at the person who buys stock with "intention or expectation" based on inside information to sell at a short-term profit and necessarily contemplates the statutory relationship, and informational access, before his purchase. Moreover, as shown in the margin, legislative discussions of the "converse" situation, where an insider sells stock "with the intention of repurchasing"[11],

10. *Senate Hearings* 6557 (emphasis supplied). The passage is quoted in *Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 593 n.23.

11. "Senator Bulkley. Do you provide for the converse of that, where a man might sell for a short term with the intention of repurchasing?

Mr. Corcoran. No; it should have been provided for. . . .

* * *

Senator Bulkley. Yes. A man having a large amount of stock might know that his company was going to pass a dividend, and then sell it with the intention of purchasing after the news was out." *Senate Hearings* 6557-58 (Feb. 28, 1934).

make evident that Congress was concerned with persons with inside knowledge before the opening transaction.

The House hearings addressed this same problem. Indeed, the bill had a provision making "tippees" of insiders liable, which set forth the *critical sequence* of acquisition of information, followed by a short-term transaction "within a period not exceeding six months after such disclosure", H.R. 7852. Mr. Corcoran stated that "tippee" liability was designed to attack the very same type of transaction foreclosed to an insider, when carried on by his "friends."[12]

> "Mr. Corcoran: Now, on page 29, subsection (3), an insider tips off somebody with his inside information . . . and the person tipped makes a short swing profit on the stock." *House Hearings* 135.

Congressmen questioned the enforceability of the tippee provision (*Id.* 135-38) and ultimately deleted it.

After three weeks of hearings on H.R. 7852, the House Committee on March 20 presented a redraft, H.R. 8720.[13] Criminal liability and tippee liability were now deleted, and the converse "sale and purchase" transactions were included. Moreover, the new version added the exemptive proviso for "shareholder-insiders", requiring that they be "insiders" both at the time of the purchase and sale, also permitted administrative exemptions, and directly tied both exemptions to language declaring the purpose of the bill:

> "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale or sale and purchase of the security involved, nor any transaction or transactions which the Commission by

12. In the Senate hearings the purpose of tippee liability was similarly described. *Senate Hearings* 6558 (February 28, 1934).

13. H.R. 8720, introduced by Rep. Rayburn and referred to the House Committee on Interstate and Foreign Commerce on March 19, 1934.

> rules and regulations may exempt as not comprehended within the purpose of this subsection of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer."

After further hearings, however, the House Committee deleted entirely the provision now known as § 16(b) and, on April 27, 1934 reported out a bill requiring insiders only to report their transactions (now § 16(a)) and refrain from short selling and selling "against the box" (now § 16(c)).[14] This was passed by the House on May 7, 1934.[15]

The Senate committee's revision, reported out on April 20, 1934, raised "insider" share ownership from 5% to 10% and adopted the exemptive proviso requiring shareholder-insiders to be such "both at the time of the purchase and sale", in apparent response to objections to treating large investors the same as officers or directors.[16] It also authorized administrative exemptions and placed the explicit statement of statutory purpose separately in the forepart of the statute.[17]

14. H.R. 9323, introduced by Rep. Rayburn and referred to the House Committee on Interstate and Foreign Commerce on April 25, 1934; reported out April 27, 1934.

15. The only House revision was a subsection excluding securities registered without the issuer's consent, H.R. 9323 as passed by the House, May 7, 1934.

16. "Senator Kean. I think it is all right to apply it to a director or officer, but I think to require the ordinary investor—

* * * * *

. . . you are interfering with the individual a good deal there. I agree with you with respect to the officers and directors.

Mr. Corcoran. A stockholder owning 5 percent is as much an insider as an officer or director. Whether he is a titular director or not, he normally is, as a practical matter of fact, a director.

Senator Kean. He might not be." *Senate Hearings* 6556.

17. S. 3420, as reported Senate, April 20, 1934. Like H.R. 8720, it included sale and repurchase transactions and deleted tippee and criminal liability.

The Senate report[18] states clearly that Congress considered access to inside information as the "basis" for initiating the special type of speculation it sought to bar:

> "The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation . . . from speculating in the stock on the basis of information not available to others,"[19]

and it specifically spoke of information obtained in advance of such trading:

> "trading in the stock of their own companies with the benefit of advance information. . ."[20]

The Senate passed this version on May 14, 1934, as an amendment to the House bill. The differences were referred to a conference, which substantially accepted the Senate version[21]. This bill became law.

Section 16(b) was presented to Congress and considered by it as a specialized tool to combat the unfair use of inside information in short-term "speculative swings"[22]. The hearings all concern the insider who obtains inside information in advance of his short-swing transaction and could "with his inside information get in and get out of stock within six months."[23]

Allis mistakenly argues that by deleting the reference to "the intention" at the time of purchase "of selling the same

18. S. Rep. No. 792, 73d Cong., 2d Sess. (April 17, 1934).

19. *Id.* 9.

20. *Id.* 9.

21. See S. Doct. No. 185, 73d Cong., 2d Sess. 16-17 (May 28, 1934); H.R. Rep. No. 1838, 73d Cong., 2d Sess. 16-17, 35-36 (May 31, 1934).

22. *Senate Hearings* 6557.

23. *House Hearings* 133.

security," Congress "intended to broaden the bill" (Allis Br. 16), though it concedes that the language clearly "tended to limit its application to transactions involving shareholders with pre-existing 10% holdings" (Allis Br. 15), as does petitioner (P. Br. 29). In fact the "intention" language was removed solely because the elimination of possible criminal liability made intention entirely unnecessary as a component of proof, but it obviously did not change the target of the statute.

Indeed, rather than "broadening" the act, Congress drastically narrowed it in several ways: by excising tippee liability, raising share ownership to 10%, authorizing administrative exemptions, delimiting the statutory purpose, and adding the exemptive proviso excluding 10% shareholders who were not such "both at the time of the purchase and sale."

No doubt the exemptive proviso expressly for shareholders responds to congressional reluctance to make the same conclusive presumption for investors as for officers and directors. See page 13, *supra*. The Senate report[24] recounts, *inter alia,* an abuse whereby two directors manipulated dividend payments to make profits in a trading pool. It has been reasoned that §16(b) might in certain cases be applied to deter "official" insiders, with inherent corporate powers, from such manipulations occurring after the purchase. The present Chief Justice, writing in *Adler v. Klawans,* 267 F.2d 840 (2 Cir. 1959), so noted in circumstances specifically showing the special power of an "official" insider:

> "Our primary holding simply gives effect to the statutory mandate which presupposes that, at some moment before making a sale of stock, the insider was in an *official position* which he *could have used to influence the sale price.* (*Supra,* 267 F.2d 845.)" *Id.* 848 (Emphasis added to emphasis in original)

24. S. Rep. No. 792, 73d Cong., 2d Sess. 9 (April 17, 1934).

The court, on specific and compelling facts, addressed managerial "manipulation" of corporate affairs to influence the price of the stock. But in doing so, the court drew a clear line between officers and directors on one hand and beneficial owners on the other:

> "The statute itself, independent of its legislative history, seems to treat directors and officers as one category of 'insiders' and 10% beneficial owners as another. There is, of course, a logical and practical basis for distinction. Generally . . . officers and directors have more ready access to the intimate business secrets of corporations and factors which can affect the real and ultimately the market value of stock than does even so large a stockholder as a '10% beneficial owner.' This is not to discount the potential influence of the [mere investor] but simply to acknowledge the basis for the different treatment accorded them by Congress. Moreover, a director or officer can usually stimulate more directly actions which affect stock values and have knowledge of factors which might depress values. Notwithstanding exceptions and variations these general propositions have a foundation in experience and furnish an adequate basis for a difference in treatment of 10% owners. *Beyond doubt it was considerations of this character which led Congress to make a provision concerning 10% owners which was not made with respect to officers and directors.*" *Id.* 845 (emphasis supplied).

An officer or director has not only a power, but a duty, to learn pertinent facts and to direct company policy. An investor, to the contrary, has no official powers (indeed he may in fact have no access to corporate information). The report summarizing the Senate investigations which led to the 1934 Act draws the same distinction. In the case of management, it pointed to:

> "the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust *and* the confidential information . . ." S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (June 6, 1934) (emphasis supplied),

while the general characterization of the investor's ability was limited to access to information:

> "stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others." *Id.*

The facts in Allis' suit against G&W point up this very distinction. The testimony of Allis' chief executive was replete with instances when critical corporate matters were kept from G&W expressly because disclosure rules forbade discussion "outside of a board of directors' room", or because the subject was "an internal matter" which "should be kept to the board of directors and the management." No G&W representative ever sat on Allis' board, nor did G&W participate in any management decisions. Indeed, Allis took every step to isolate what it has described as an "unwanted mate". The district court concluded "that Allis sought to discourage G&W's retention of its stock position in Allis." 372 F. Supp. at 579.

The contentions that certain "exemptions" prove by indirection that § 16(b) attacks an initial purchase by an "outsider" (because otherwise the exemption would be unnecessary) are clearly backwards bootstrapping, and they are erroneous on other grounds. For example, the discussion of arbitrage (P. Br. 30; Allis Br. 16; *Senate Hearings* 7567) reflects concern that an arbitrageur may "accumulate more than 5 percent," become a statutory "insider", and be restricted in trading by the act, "which imposes penalties upon a stockholder owning 5 percent or more . . ." *Id.* Such discussion is not directed to the initial purchase. Indeed,

arbitrage by preexisting "insiders" initially raised § 16(b) questions, see *Falco* v. *Donner Foundation, Inc.*, 208 F.2d 600 (2 Cir. 1953), but these were resolved by § 16(d) (now § 16 (e)), exempting arbitrage transactions. Moreover, contrary to the statement at Allis Br. 17, the arbitrage subsection was not even in the bill[25] discussed in the passage quoted.

Rule 16b-2 (P. Br. 24, 30; Allis Br. 17) is likewise unhelpful to petitioner and Allis, for it too applies to officers, directors, and preexisting "beneficial owners". Indeed, in explaining Rule NB2, the ancestor of Rule 16b-2, the SEC clearly had the model of a pre-existing relationship in mind:

> "The new Rule NB2 affords an exemption for certain cases by providing that underwriters who happen to have a member of their firm also an officer or director of the issuer or one of its principal stockholders who are regularly engaged in the business of buying and selling securities need not account to the company for profits realized from purchases and sales made in the distribution of a security for the company, provided that independent underwriters have a participation in the underwriting of at least 50 per cent on identical terms." SEC Securities Exchange Act Release No. 264 (June 8, 1935).

Finally, petitioner and Allis swing wide of the mark in trying to divine the intent of the 73rd Congress from § 16(d) (P. Br. 30; Allis Br. 17), apparently overlooking the fact that this subsection 16(d) was passed by the 88th Congress in 1964.[26]

25. H.R. 8720; see *Senate Hearings* 7539.

26. Apart from the anachronism, their logic is erroneous. Section 16(d) leaves untouched market-making transactions by a dealer previously holding securities of the issuer in a segregated "investment" account, but it fully exempts persons previously holding over 10% in "trading accounts" as well as dealers who are officers or directors. *See* H. R. Rep. No. 1418, 88th Cong., 2d Sess. (1964), U.S. Code Cong. & Admin. News, 88th Cong., 2d Sess. 3025, 3042-43 (1964).

C. The elaborate theories advanced to support first-transaction liability conflict with the legislative purpose and the logic of the statute itself.

Very much mistaken as to the legislative history, the proponents of liability indulge in latter-day creation of new rationales. Allis relies exclusively upon the theory of "after-acquired information", claiming that a "purchase of a large block of securities followed by access to inside information and sale thereof within a six-month period was precisely the situation intended to be covered by § 16(b)" (Allis Br. 5). Congress intended precisely the opposite, as shown above, and included only transactions in which inside information precedes and motivates the first transaction, so that a "sure-thing" profit can be made in the second.[27] The "initial transaction . . . is an anticipatory action based upon inside information, and the terminal transaction is the profit-taking action." Comment, *supra*, 20 U.C.L.A. L. Rev. at 1295 (footnote omitted). To base automatic liability on access to information only after the first transaction departs from the aim of the statute and cannot be justified. *Id.* 1295-97. *Accord: Gold* v. *Sloan*, *supra*, 486 F.2d at 349. Possible use of information acquired after the initial transaction, commentators have noted, is simply not a § 16(b) problem—but clearly is a 10b-5 problem. Note, *supra*, 72 Mich. L. Rev. at 607 n.55; Note, *supra*, 117 U. Pa. L. Rev. at 1042 n.39; *Lowenfels*, *supra*, 54 Cornell L.Q. at 61-63.

27. "[T]he terms of the statute and its legislative history, both . . . indicate that only double-transaction abuse rather than single-transaction abuse was intended to be reached. The congressional hearings . . . repeatedly describe its purpose in terms referring to double- rather than single-transaction abuse—the curbing of 'short-term', 'in-and-out' speculation on the basis of inside information. Furthermore, the examples in the congressional hearings and reports of the kind of abuse intended to be reached by section 16(b) include no instances of single-transaction abuse, but in all cases describe situations in which advance information tainted both the purchase and the sale." Note, *supra*, 72 Mich. L. Rev. at 602-03.

Indeed when such a theory of liability is tested, the structure of the statute breaks down. For example, the six month period, "under the statute itself, is assumed to dissipate whatever trading advantage might be imputed to a major stockholder", *Kern County Land Co.* v. *Occidental Petroleum Corp., supra,* 411 U.S. at 603. But if liability is based on supposed information acquired *after* the six months start to run, "the six month time period is illogical", Note, *supra,* 72 MICH. L. REV. at 605. The key provision "loses its efficacy as a presumptive device", Comment, *supra,* 20 U.C.L.A. L. REV. at 1297.

Moreover, the presumption of abuse which is the core of the statute simply cannot apply. Section 16(b) presumes that a short-term purchase and sale preceded by access to inside information is abusive. But no inference can arise if only the sale can be connected with hypothetical inside information:

> "[R]ecovery under section 16(b) is based on a presumption of abuse arising when an insider buys and sells at a profit within six months. . . . If the statute were read to reach single-transaction abuse, the required facts would be insufficient to justify the presumption of actual abuse. The occurrence of two transactions within a short time—a fact that would otherwise indicate double-transaction abuse—cannot justify the presumption of guilt when the initial transaction is, by hypothesis, unrelated to the later transaction." Note, *supra,* 72 MICH. L. REV. at 607-08.

Similarly, such a theory renders the statutory measure of recovery wholly inappropriate. Recovery under § 16(b) is the difference between the purchase price and the sale price —which works well when the theory is that the insider bought stock with inside information, realizing his profit upon the sale. But under a theory based upon post-acquisition information, this measure of recovery does not work

at all, for the insider can only sell at a price higher than some other selling price. The measure of his unfair advantage is the difference between these two selling prices. Section 16(b) cannot measure that profit (Rule 10b-5 can, however[28]). Only by accident will the difference between the purchase price and sale price equal the difference between the two sale prices. The investor would pay a recovery as if he purchased with inside information, which by hypothesis cannot be presumed.

This gross incompatibility between the spurious post-purchase information theory and the statute's operation[29] has serious Constitutional implications beyond the demonstrable conflict with Congressional intent. Section 16(b), which imposes liability in the absence of actual wrongdoing, has

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28. Under Rule 10b-5 the damage award attacks the abuse precisely; a wrongdoer can be charged with the difference between his sale price and the market value that the stock attained after the inside information became public. *See, e.g., SEC* v. *Texas Gulf Sulphur Co.,* 446 F.2d 1301, 1307-08 (2 Cir. 1971), *cert. denied,* 404 U.S. 1005 (1972).

29. This incompatibility always compels a recovery which bears ***no relation at all*** to the "profits" made by use of inside information, *e.g.:*

An outsider buys over 10% of an issuer's stock for $20 per share. The stock soon rises to $50 per share. Less than 6 months after his purchase he learns unfairly that earnings will decline, and he sells for $50 per share. When the lower earnings are made public, the market price drops from $50 to $45. By his abuse of information he has gained an unfair advantage of $5 over the public stockholders. But Allis' theory would charge him with a $30 recovery instead.

Or take the converse case: He initially purchases stock at $20 per share, and it rises to $25 in five months. At that time he learns "inside information" that earnings will be seriously cut, and he immediately sells his stock at $25. When the news comes out the stock tumbles from $25 to $10 per share. Clearly by his abuse of inside information he has gained an unfair advantage of $15 over public stockholders. But Allis' theory would charge him with only a $5 recovery.

All such results are obviously irrational. The only time an insider would be charged with an amount related to his unfair gains is if the appreciation of his stock while he owns it exactly equals its decline after his sale, and such an instance is sheer accident.

been sustained only on the basis of its "remedial" quality calling for forfeiture only of "unfair profits", and a reasonable relationship to the supposed unfair conduct.[30] But in the case of an outsider's purchase, the result is a capricious, irrational penalty, bearing no relationship to any "profit realized" from "the unfair use of information".

Petitioner quotes an argument once made by the SEC, as *amicus curiae*[31], suggesting that an over-10% investor must have pre-purchase inside information since he "necessarily would deal in the negotiations looking toward the purchase, with either the issuer or an insider holding a large interest in the issuer" (P. Br. 27). Obviously this theory is woefully inadequate in describing the likely means of achieving a stock interest, and, in addition, relies upon a presumption contrary to the statute itself.[32]

This Court expressly rejected such an imputation in *Kern County,* where it held claims of information based on "substantial stockholdings that did not yet exist" to be improper, 411 U.S. at 597. Similarly, to base liability on a supposed pre-purchase "tip" from an insider is also clearly improper, since Congress deliberately deleted "tippee" liability, and it would impermissibly expand liability beyond those "specifically designated by Congress to suffer those losses."

30. *Smolowe* v. *Delendo Corp.,* 136 F. 2d 231, 239 (2 Cir.), *cert. denied,* 320 U.S. 751 (1943); *see also Booth* v. *Varian Associates,* 334 F. 2d 1, 3 (1 Cir. 1964), *cert. denied,* 379 U.S. 961 (1965); *Adler* v. *Klawans, supra,* 267 F. 2d at 844.

31. Brief for SEC as Amicus Curiae at 5-6, *Stella* v. *Graham Paige Motors Corp.,* 104 F. Supp. 957 (S.D.N.Y. 1952).

32. Indeed, this merely points out another valid distinction between managerial insiders and shareholders. The latter can acquire their position without any inside access, through exchange and tender offers and market purchases, some of which may indeed require extensive prepurchase disclosure. Certainly, Congress refused to presume that one who becomes a "beneficial owner" had a prior insider's relationship, since all concede that it exempted purchases occurring before 10% status, even if there are short-term sales occurring after the statutory status has been reached.

Reliance Electric Co. v. *Emerson Electric Co., supra,* 404 U.S. at 427; *Blau* v. *Lehman, supra,* 368 U.S. at 411.

Petitioner seems to argue at length (P. Br. 33-35) that this Court's refusal to presume access to information in the absence of the required shareholdings was erroneous, by claiming that the statutory language can be construed to include ownership of securities convertible into the required holdings or binding contracts to buy such holdings. The short answer is that the argument is irrelevant where the investor holds no securities of the issuer whatever before the purchase (much less common stock equivalents) and holds no such contract. Indeed, whether a particular contract for the purchase of securities can be the basis for a §16(b) claim depends, at the least, upon affirmative proof that it conveyed substantial prepurchase rights of ownership and was intertwined with unfair access to inside information (see *Newmark* v. *RKO General, Inc.,* 425 F.2d 348, 356 (2 Cir.), *cert. denied,* 400 U.S. 854 (1970))—the very elements which petitioner would assume by means of an improper presumption.

Petitioner's argument that an investor could acquire over ten percent in hopes of manipulating market prices to sell at a profit (P. Br. 28) simply ignores the limits and stated purpose of § 16(b). It clearly was not designed to provide recovery based on every litigant's fantasized claims of hypothetical wrongdoing. There are extraordinarily effective federal remedies for actual wrongdoing. Indeed, the claim that "official" insiders' liability is an "analogous issue" to the question presented here (P. Br. 15) is plainly erroneous, for it ignores precisely the distinction which the statute draws.[33]

Nor is it relevant that the acquisition of over ten percent must be reported pursuant to § 16(a) (P. Br. 32), since

33. Thus cases involving officers or directors (P. Br. 23) are inapposite here.

§ 16(a) reporting rules are not intended to determine § 16(b) liability, see *Chemical Fund, Inc.* v. *Xerox Corp.*, 377 F.2d 107, 112 (2 Cir. 1967); *Silverman* v. *Landa*, 200 F. Supp. 193, 195 (S.D.N.Y. 1961), *aff'd*, 306 F.2d 422 (2 Cir. 1962), and serve different purposes,[34] including publicity alone. See H.R. REP. No. 138, 73d Cong., 2d Sess 13 (1934).

Finally, petitioner argues that the "outsider's" estimates of the future value of the assets he exchanges for stock (P. Br. 53-55), may be substituted for the required access to confidential information of the issuer. This is a baseless expansion of the statute, applicable only when the acquisition is from the issuer, and then only when nonmonetary consideration is paid, and as such is clearly not a credible, much less authentic, basis for "automatic" liability.

D. The decisions of this Court clearly reject the attempt to take § 16(b)'s automatic liability beyond its intended limits.

It seems to be contended (P. Br. 36; Allis Br. 8) that the Court in *Kern County* decided that an outsider's over-ten per cent purchase is chargeable since the Court went on to decide whether a "sale" took place. Initially, it is simply unacceptable to argue that this Court, which expressly reserved the issue in *Reliance Electric* where it was arguably involved (404 U.S. at 421), would decide it by indirection in *Kern County,* where it was not involved at all. There Occidental made an unconditional tender offer and bought shares in many separate transactions as they were tendered. *After* acquiring over 10% it extended its offer and made a series of purchases *after* becoming a "statutory insider". See 411 U.S. at 591 n.20, 598. Occidental never

34. "It is recognized that many reports are required by Section 16(a) of transactions which are not subjected to Section 16(b) liability." SEC Securities Exchange Act Release No. 4801 (Feb. 20, 1953).

raised the first-purchase issue because it was immaterial,[35] and Occidental had more important concerns. Rather, it sought to free *all* shares from liability by attacking the alleged "sale".

To the contrary, the analysis in *Kern County* certainly bars liability here. There, the Court noted that Occidental lacked large shareholdings, and it thus viewed its initial purchases as statutorily innocent, even though made in a cash tender offer which required no prospectus disclosure:

> "[I]t owned only 1,900 shares of Old Kern stock, far fewer than the 432,000 shares needed to constitute the 10% ownership required by the statute. There is no basis for finding that, at the time the tender offer was commenced, Occidental enjoyed an insider's opportunity to acquire information about Old Kern's affairs." *Id.* 596-97.

Rejecting the contention that Occidental should be held to have foreseen a profitable "defensive" merger, the Court said:

> "Calculations of this sort, however, whether speculative or not and whether fair or unfair to other stockholders or to Old Kern, do not represent the kind of speculative abuse at which the statute is aimed, for they *could not have been based on inside information obtained from substantial stockholdings that did not yet exist.*" *Id.* 597 (emphasis supplied).

Even though Occidental had extended its offer *after* it became a 10% "beneficial owner" and bought more stock, the

35. The 10% purchase issue was worthless to Occidental and was not argued. Occidental purchased stock piecemeal as it was tendered, and the initial purchase that put it over 10% was a single tender at 2:46 p.m. on May 10, 1967. Excluding that initial purchase was meaningless to Occidental. Instead, it sought exclusion of all sub-10% purchases. Brief for Defendant-Appellant at 85, *Abrams* v. *Occidental Petroleum Corp.*, 450 F.2d 157 (2 Cir. 1971), *aff'd sub nom. Kern County Land Co.* v. *Occidental Petroleum Corp., supra.*

Court rejected liability in light of the hostile relationship with the issuer. And, treating the option issue in that case, the Court stressed again the need for actual ownership in the issuer:

> "Occidental had no *ownership position* in Tenneco *giving it any actual or presumed insights* into the future value of Tenneco stock. That was the *critical item of intelligence* . . ." *Id.* 603 (emphasis supplied).

Under this decision it simply cannot be argued that an initial 10% purchase by an outsider with no previous "relationship to the issuer" could be viewed as tainted.

None of the remaining decisions cited by petitioner and Allis, to the extent they remain viable after *Kern County,* support liability here.

Newmark v. *RKO General, Inc., supra,* expressly rejects the idea that an "outsider's" purchase could be based on inside information, 425 F.2d at 356. There the court found that the defendant became a statutory "beneficial owner" and actually had inside information *before* making its purchase,[36] and it put liability on that basis:

> "At the time it secured a conditional right to purchase Central securities, RKO *was in possession of advance information* of the type most likely to affect the price of Central shares—confidential knowledge of an impending merger with Frontier." *Id.* (emphasis supplied).

36. "[O]n the facts before us, we have no difficulty in deciding that RKO became a beneficial owner of more than ten percent of Central's common stock before its purchase of Central shares. . . . RKO entered into an agreement which granted it a conditional right to purchase more than 50% of Central's common stock at a fixed price, ensured that Central would be managed in accordance with its interests, and required a majority of Central shares to be voted in support of a merger it favored. This contract, we conclude, granted rights of ownership, particularly those rights most important to the speculative purchaser, so substantial as to make RKO a ten percent beneficial owner of Central at that time." 425 F.2d at 356.

Thus the transaction occurred in the critical statutory sequence:

> "Accordingly, we conclude that RKO *became a Central insider, purchased* Central securities and, less than six months later, *sold* these securities." *Id.* (emphasis supplied).

Allis relies (Allis Br. 9-11) on the lower court ruling in *Emerson Electric Co.* v. *Reliance Electric Co.,* 434 F.2d 918 (8 Cir. 1970), on a point not pursued in this Court, but this decision is of infirm validity after *Kern County.* The investor in *Emerson* bought 13% ownership in a pre-Williams Act cash tender offer and urged that the purchase was excluded by the exemptive proviso. The court sought to justify liability on the basis of a situation not before it, hypothesizing "potential mischief" different from the statute's intended target:

> "Illustrative of some of the mischief that would be permitted in spite of Congress' action in enacting 16(b) if we accorded with Emerson's contentions is an initial purchase of as large a block of stock as 51 percent or more of a corporation's stock, followed by a sale any time within six months by the stockholder who obviously within that period could obtain much inside information and also could influence, manipulate, or control corporate transactions. The deterrence of such apparent potential mischief must have been within the contemplation of Congress." *Id.* 924.

To base liability on a hypothetical 51% acquisition followed by supposed manipulation, when the case actually involves a non-controlling 13% shareholder rejected by management, conflicts with *Kern County,* under which courts are to consider "whether *the transaction* may serve as a vehicle for the evil Congress sought to prevent," 411 U.S. at 594 (em-

phasis supplied); see also *id.* 594 n.26, 595. Furthermore, at least insofar as § 16(b) relates to mere investors, its expressed concern is abuse of information, not hypothesized manipulation. *Adler* v. *Klawans, supra.*

More basically, the Eighth Circuit was primarily motivated by the thought that § 16(b) should include any "profits" from opportunities created by defensive tactics in contests for control:

> "An insider engaged in a contest for control of its stock issuer may have substantial opportunity for short-term profits perforce of its substantial stock ownership. In less than three months from its stock purchase Emerson apparently had made substantial short term profits related to its stock acquisition activities in its effort to gain control of Dodge." *Id.* 924 (footnote omitted).

But the Court in *Kern County* later held, expressly to the contrary, that use of inside information—not calculations related to contests for control or the advantage of "leverage" from "large stock ownership itself", 411 U.S. at 602—is the only concern of § 16(b). "If there are evils to be redressed by way of deterring those who would make tender offers, § 16(b) does not appear to us to have been designed for this task." *Id.,* 597-98.

The facts in *Stella* v. *Graham-Paige Motors Corp.,* 104 F. Supp. 957, *aff'd in part, remanded in part,* 232 F. 2d 299 (2 Cir.), *cert. denied,* 352 U.S. 831 (1956), do not support liability here.[37] *Stella* involved a large shareholder which cofounded the issuer and originally owned 50% of its stock, which holdings were recently diluted through newly issued

37. The entire "first purchase" issue in *Stella* was actually moot, because there was no "profit realized", *Stella* v. *Graham-Paige Motors Corp.,* 259 F. 2d 476 (2 Cir. 1958), *cert. denied,* 359 U. S. 914 (1959), and profit is a substantive element of liability under § 16(b), *Blau* v. *Lamb,* 163 F. Supp. 528, 532 (S.D.N.Y. 1958).

shares to 6.25%. Its purchase, raising its interest to 21%, was made pursuant to a voting trust agreement with the other founder of the company, which itself owned 9.25% of the stock (104 F. Supp. at 958). The court was faced with an insider-in-fact before the purchase.

The court interpreted § 16(b) solely to deter double-transaction abuse, where inside information *pre-dates* both the purchase and the sale. The defendant argued that an initial transaction could never create liability, but the court raised the problem of persons with a *previous* inside "relationship to the issuer" (the very case before it):

> "If the construction urged by the defendant is placed upon the exemption provision, it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum." 104 F. Supp. at 959.

Obviously this reasoning only applies in a case of *recurrent* insider status (as in *Stella* itself) and would have no bearing on an investor with no previous relationship to the issuer. Moreover, the expansionist basis of *Stella* is not viable after *Reliance Electric.* There the Court, holding that the exemptive proviso excluded the second sale, specifically rejected so-called "policy" arguments designed to bring it within the act by evidence of a pre-existing intent, or by using a "presumption of a taint" based on a recent, but not current, "inside" relationship (404 U.S. at 423, 424).

The general claims that this Court should ignore the terms and delimited purpose of the statute in order to construct liability and thus prevent supposed "loopholes" or "evasions" of the "policy of § 16(b)" (P. Br. 28; Allis Br. 9) merely beg the question by assuming that Congress intended the "proofless" recovery of § 16(b) to be applied loosely and without limits, and specifcially err in ignoring

precedents against "adding to the 'prophylactic' effect Congress clearly prescribed in § 16(b)", *Blau* v. *Lehman, supra,* 368 U.S. at 411.

The statutory exemption cannot be ignored, *Reliance Electric Co.* v. *Emerson Electric Co., supra,* 424, but must be construed by "endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits." *Kern County, supra,* 411 U.S. at 594-95. Those objectives cannot be served by imposing a liability which is fabricated by artificially attaching the label of "insider trading" to an innocent transaction by an outsider, and presuming unfairness without any foundation in reason or fact, contrary to the legislative intent.

Conclusion

The judgment of the Court of Appeals for the Ninth Circuit is correct in its application of §16(b) and should be affirmed.

Respectfully submitted,

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